

THE HONORABLE MARSHA J. PECHMAN

UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON  
AT SEATTLE

COSTCO WHOLESALE CORPORATION, a  
Washington corporation,

Plaintiff,

v.

ROGER HOEN, VERA ING, and MERRITT  
LONG, in their official capacities as members  
of the Washington State Liquor Control Board;

Defendants, and

WASHINGTON BEER AND WINE  
WHOLESALE ASSOCIATION, a  
Washington non-profit corporation;

Intervenor Defendant.

NO. CV04-0360P

PLAINTIFF'S EXPERT REPORT OF  
KEITH LEFFLER

Attached is a true and correct copy of Plaintiff Costco Wholesale Corporation's  
Expert Report of Keith Leffler in addition to Exhibits A, B, C-1, C-2, and C-3 in support  
thereof.

DATED: June 3, 2005.

**PLAINTIFF'S EXPERT REPORT OF KEITH LEFFLER  
(NO. CV04-0360P)- 1**

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**PLAINTIFF'S  
EXHIBIT**

CASE  
NO. **CV04-0360P**

EXHIBIT  
NO. **239**

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**CERTIFICATE OF SERVICE**

I certify that on June 3, 2005, I caused to be served upon counsel of record, listed below, via email, an electronic true and correct copy of the foregoing Plaintiff's Expert Report of Keith Leffler to the following:

<p>David M. Hankins Assistant Attorney General 905 Plum St., Bldg. 3, Flr. 2 Olympia, WA 98504-0123 <u>DavidH1@ATG.WA.GOV</u></p> <p>Attorney for Roger Hoen, Vera Ing, and Merritt Long</p>	<p>John C. Guadnola Gordon, Thomas, Honeywell, Malanca, Peterson &amp; Daheim LLP 1201 Pacific Ave., Suite 2100 Tacoma, WA 98401-1157 <u>jguadnola@gth-law.com</u></p> <p>Attorneys for Intervenor Defendant Washington Beer and Wine Wholesalers Association</p>
<p>Paul R. Romain 1900 Fox Tower 805 SW Broadway Portland, OR 97205-3359 <u>promain@teleport.com</u></p> <p>Attorney for Intervenor Defendant Washington Beer and Wine Wholesalers Association</p>	

I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED: June 3, 2005 at Seattle, Washington.

By: Shylah R. Alfonso  
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Corporation

**PLAINTIFF'S EXPERT REPORT OF KEITH LEFFLER  
(NO. CV04-0360P)- 3**

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**Qualifications**

1. I am an Associate Professor of Economics at the University of Washington. I received my Ph.D. in Economics in 1977 from UCLA. I have teaching and research experience in the area of industrial organization. My specialty within industrial organization is the study of competition. I have taught classes and conducted research in this area of economics for over thirty years.
2. I have been performing economic analysis in matters related to litigation since 1976. I have been qualified as an economic expert in proceedings before federal courts, state courts, the Federal Trade Commission, and federal and state regulatory agencies. I have analyzed economic issues related to distribution and retailing in a number of industries, including gasoline, prescription drugs, cigarettes, and, more generally, products sold by grocery stores. I also have familiarity with Costco from prior consulting work done for the Washington State Attorney General and for Costco. A Curriculum VitaeCHECK is attached to this Report as Exhibit A. My experience, qualifications, publications and testimony given in the last four years are summarized therein. I am charging Costco my usual hourly rate of \$500 and my expenses.

**Area of Analyses and Bases for Opinions**

3. I have been asked by counsel for Costco to analyze the competitive impact of certain regulations and statutes enforced by the Washington State Liquor Control Board (WSLCB).<sup>1</sup> In order to perform this analysis, I have reviewed the complaint and answers to the complaint, interrogatories and answers to interrogatories, WSLCB regulations, documents obtained in discovery from WSLCB and wine and beer distributors, interviews of Costco buyers, and data

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<sup>1</sup> For convenience I refer to the relevant regulations and statutes as WSLCB regulations.

obtained from Costco. I have also relied upon my economics training and experience.

### **Opinions**

4. I have reached a number of opinions concerning the competitive impact of certain WSLCB regulations.
5. The fundamental economic concern with regulations such as those enforced by the WSLCB is that they will stifle competition and lead to higher, economically inefficient prices. A number of the relevant regulations are expected to have exactly these impacts.
6. Retailers seeking lower prices can be an important factor in limiting the ability of distributors to reach and sustain cooperative, above competitive prices. WSLCB regulations prohibit distributors from offering some buyers lower prices unless all buyers are also offered lower prices.<sup>2</sup> This reduces the expected gains from any such price cuts because the distributor will incur losses on those sales that could have been made at the higher price. Thus, the WSLCB regulations requiring that all buyers receive the same prices lead to higher, inefficient prices are therefore anticompetitive.
7. Quantity discounts can be a way for distributors to reward retailers for lowering distributor costs through, for example, lower delivery costs or economies of reduced billing costs. Quantity discounts can also be a way to move merchandise in situations of distributor overstocking by shifting inventory costs to the retailers. Quantity discounts can, therefore, be a mechanism motivating innovative retailer search for greater efficiencies. Such efforts are expected to lead to lower prices.
8. WSLCB regulations prohibit quantity discounts.<sup>3</sup> This prevents the distributors from motivating retailers to seek ways of lowering distributors' costs as related

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<sup>2</sup> RCW 66.28.180(2)(a).

<sup>3</sup> RCW 66.28.180(2)(d).

to the retailers' volume of purchase.<sup>4</sup> The WSLCB regulations therefore interfere with one of the fundamental benefits of a competitive market, namely, the ability of a seller to offer buyers a better deal if a buyer cooperates to accomplish a more efficient method of doing business. The WSLCB regulations prohibiting quantity discounts are therefore anticompetitive.

9. The ability of retailers of wine and beer to bypass distributors by purchasing directly from manufacturers is one factor that can limit the ability of distributors of wine and beer to reach and sustain above competitive prices. In effect, such direct manufacturer purchases by the retailer substitute the retailer for the distributor, with the retailer performing the distribution function. This has the effect of increasing the competitiveness in the distribution sector of the industry and, thereby, increasing economic efficiency and likely leading to lower consumer prices.
10. WSLCB regulations prohibit distributors of wine and beer from delivering to the warehouse of retailers.<sup>5</sup> This regulation prevents retailers such as Costco from taking advantage of their internal distribution efficiency. Such a constraint on the potential for retailers to effectively compete in offering certain distribution services is therefore anticompetitive.
11. WSLCB regulations prohibit retailers of wine and beer from purchasing directly from out-of-state manufacturers.<sup>6</sup> This regulation therefore eliminates the retailers' ability to combat any above-competitive distributor pricing for out-of-state product. By protecting the distributor from the competition of retailers willing to perform the distribution function, the WSLCB regulation is anticompetitive.
12. Competition on ancillary pricing components such as credit and delivery terms is more difficult to monitor and police than is competition on price itself.

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<sup>4</sup> Manufacturers are also restricted from giving quantity discounts. RCW 66.28.180(3)(b). This will also constrain competition by limiting the distributors' abilities to seek special volume-related deals from manufacturers that could be passed on to the retail buyers.

<sup>5</sup> RCW 66.28.180(2)(h)(ii).

<sup>6</sup> RCW 66.28.070, WAC 314-36-020. WSLCB regulations allow for direct purchase from Washington producers.

Therefore, competition on such ancillary terms can undermine the cooperative, above-competitive pricing that can occur in the distribution of wine and beer.

13. WSLCB regulations prevent competition on credit and delivery terms.<sup>7</sup> This prevents wine and beer distributors from deviating from above competitive pricing except via reductions to the “list” price. Since such deviations from list price would be expected to lead to rapid competitive responses from other distributors, the inability to compete on credit and delivery terms increases the likelihood that above-competitive pricing will be sustained. The WSLCB regulations preventing competition on credit and delivery terms are therefore anticompetitive.
14. Some retailers, like Costco, specialize in low prices. Such retailers' success in this regard is dependent, in part, on the ability to achieve low costs through use of innovative purchasing techniques, innovative distribution techniques, and bargaining with its suppliers. The WSLCB regulations restricting low cost retailers like Costco from taking advantage of any warehousing innovations (delivered pricing, no warehouse delivery), ability to obtain low prices (same price to all), delivery innovations (no out-of-state direct purchase), and buying efficiencies (no quantity discounts) all interfere with the competitive system by supporting less efficient retailers other buyers rather than more efficient buyers.
15. In a competitive market, prices provide the signals to consumers as to the efficient (low price) and less efficient (higher price) sellers. These price signals also provide information about the likely level of services offered by various sellers. Through buyers' responses to these price signals, economic efficiency is enhanced; that is, those sellers offering a better price-service-quality bundle will have greater sales and profits. WSLCB regulations prevent these price signals from carrying the proper information to consumers. As a result of this interference with price signals, the WSLCB regulations impede

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<sup>7</sup> RCW 66.28.180(2) (h)(ii), WAC 314-13-015.

the working of the competitive market to the ultimate detriment of economic efficiency.

16. Mechanisms that increase the transparency to the sellers of the prices set by the wine and beer distributors will facilitate and increase the likelihood of reaching and sustaining above competitive prices. This is because competitors will reliably learn of actual prices being charged to purchasers at relatively low cost. When competitors easily learn that one seller is offering a good deal in order to increase market share, those competitors are expected to react by quickly matching the competitive foray of the price cutter. This has the effect of reducing the gain from such competitive efforts and thereby reducing the incentive to ever engage in such actions.<sup>8</sup>
17. WSLCB regulations require wine and beer wholesalers to post their prices.<sup>9</sup> In conjunction with the inability to deviate from this "list" in other dimensions such as credit terms, delivery terms, quantity discounts or customer specific deals, this alerts competitors to exactly the price to be charged all buyers. The expected result is to reduce the incentive of the distributors to engage in vigorous price competition. Therefore, the WSLCB regulations requiring posting of prices are anticompetitive.
18. WSLCB regulations also require wine and beer distributors to hold their posted prices for 30 days.<sup>10</sup> This regulation therefore prevents distributors from offering short term promotions. Any price "cut" must be maintained for a minimum of thirty days regardless of competitors' reactions. This again reduces the incentive to experiment and test the market response to more vigorous pricing. The expected result is less price competition and higher prices. Therefore, the WSLCB regulations requiring the holding of posted prices for 30 days are anticompetitive.

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<sup>8</sup> See, for example, Carlton and Perloff, *Modern Industrial Organization*, fourth edition, pp. 136 and 191 for a discussion of the role of price transparency in supporting above competitive prices.

<sup>9</sup> RCW 66.28.180(2).

<sup>10</sup> WAC 314-20-100(2) & 314-24-190(2).



19. Wine and beer distributors are also required to post prices 20 days prior the prices taking effect, while manufacturers must post 35 days in advance.<sup>11</sup> This makes it very difficult for the market to respond to any special needs for price changes in a timely fashion.<sup>12</sup> This regulation therefore impedes the market's ability to respond to any short run supply and demand imbalances in an efficient manner. As a result, the WSLCB regulations requiring advance price posting by wine and beer distributors are anticompetitive.
20. Minimum markups fix the price of a product to be equal to or greater than the cost of the product plus the minimum markup. Such a price floor is inconsistent with competition. This is true even if the price floor is below the average price under competition, since it eliminates the opportunity to engage in special pricing deals.
21. WSLCB regulations require wine and beer distributors to set a minimum markup of 10 percent.<sup>13</sup> From discussions with Costco buyers, it is apparent that special deals below the Washington minimum markup do arise in other states where not artificially constrained. Such special deals can arise, for example, when a distributor has the desire to sell slow moving product, or has the opportunity to lower costs through some special distribution arrangement with the manufacturer. Therefore, by eliminating the possibility of competitive, low prices from low margins, the WSLCB minimum markup regulation is anticompetitive.
22. The anticompetitive impacts of the WSLCB regulations noted above are conceptually no less than if the same rules were implemented and effectively enforced by a horizontal agreement among competitors. The actual anticompetitive impact of these regulations is, however, greater than if the same regulations were adopted by a horizontal agreement among competitors. This is because private anticompetitive agreements are subject

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<sup>11</sup> WAC 314-20-100(2) & 314-24-190(2).

<sup>12</sup> For example, a national publication may run a very favorable review of a particular wine that increases the demand in Washington. The manufacturer may wish to respond to possible shortages by increasing the price but is constrained to the 35 day notification and the 30 day posting.

<sup>13</sup> RCW 66.28.180(2)(d).

to substantial incentives to cheat on the agreement. In contrast, the WSLCB regulations are backed by the actual or perceived enforcement powers of the state.

23. Data on the prices of wine and beer sold in California versus the same products sold in Washington support my opinion as to the anticompetitive impacts and inefficient consequences of the noted WSLCB regulations. California is subject to less regulation at the distribution and retail stages of the industry than is Washington.<sup>14</sup>
24. I have identified twenty-one beer items that were purchased by Costco in both Washington and California during the years 2003-2005.<sup>15</sup> The average prices paid including taxes are shown in Exhibit B along with the prices net of tax and net of California container deposits of four cents per bottle or can that is included in the price. There are fifty-three price-year comparisons that can be made for the twenty one items. As shown in Exhibit B, on average the price paid by Costco for purchases in Washington was 4.8 percent above that paid in California (for every dollar spent on beer purchases in California, the same items would cost \$1.048 in Washington).<sup>16</sup>
25. Exhibit B also compares the prices paid for four champagne items that were purchased both in Washington and in California.<sup>17</sup> For champagne, the Washington price to Costco was 8.1 percent more than when the same items were purchased in California.
26. Exhibit B also compares twenty-six wine items that Costco purchased in Washington and in California. I include all non-California wines that were

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<sup>14</sup> For wine, I understand that California has no price posting or uniform price regulations, and California allows quantity discounts. For beer, I understand that California does have price posting with 10 days advance notice (though prices can be dropped to meet competition) and uniform prices by trading area. I also understand that for both wine and beer California does not require delivered pricing, or minimum markups. I also understand that for beer and wine California allows credit to and warehousing by retailers.

<sup>15</sup> The years are Costco fiscal years. The Costco fiscal year runs from approximately September through August. Some of the items were not purchased in each state each of the years 2003, 2004 and 2005.

<sup>16</sup> This is the average of the ratios of the Washington prices to the California prices. This weights each item-year comparison equally.

<sup>17</sup> As discussed below for wine, I exclude champagne from California.

purchased in both Washington and California during any year 2003, 2004 or 2005. I exclude California wines to control for any transportation differentials that would imply lower costs in California. The included wines come from Europe (E in the source SRC column of Exhibit B), Australia (A), Oregon (O), Chile (S), and Washington (W). A total of seventy-two price-year comparisons are available. The average cost to Costco of purchasing the wines was 4.1% greater if purchased in Washington than if purchased in California.

27. I have also examined the stability of distributor wine prices in Washington.

Data was obtained from the WSLCB on the price postings of selected products for March 2003, September 2003, March 2004, September 2004, and March 2005 by both distributor and manufacturer (or importer). I found 1236 cases in which I could follow a distributor's price over time.<sup>18</sup> This data is shown in Exhibit C1-C3.<sup>19</sup> In over forty percent of these situations, there was no price change. I then looked at all cases in which I had a price for March 2003 and a price two years later for March 2005. There were 602 such cases. Again, in over forty percent of these situations, the price in March 2005 was identical to that in March 2003. This price stability is striking evidence of the lack of effective competition among distributors.

28. I am aware of no pro-competitive impacts that flow from any of the discussed WSLCB regulations. To the extent that defendants' experts claim any such pro-competitive impacts, I will evaluate the claims and supplement this report. I also understand that discovery is on-going. To the extent that additional discovery information alters any of my opinions or the bases for my opinions, I will supplement this report.

29. I have examined numerous contracts between wine and beer manufacturers and Washington distributors. Most of these agreements provide the distributors with exclusive territories or prevent out-of-territory sales. These agreements therefore eliminate intra-brand geographical competition between

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<sup>18</sup> I include all cases in which there were 2 or more successive prices.

<sup>19</sup> Note that unlike Exhibit B, these are individual distributor-product prices rather than the average price paid to multiple distributors.

distributors. An economic justification for such territorial sales restrictions can be to support distribution to small retailers and bars and restaurants for which the distribution cost is relatively high. Even though there is a high cost of distribution to such entities, the manufacturer desires the relatively ubiquitous distribution of the manufacturers' brands to maintain brand loyalty. Efficient low margin, low price retailers such as Costco would offer an alternative source of supply to small retailers and bars and restaurants.

30. WSLCB regulations prohibit retailers such as Costco from selling for resale.<sup>20</sup>

This removes an alternative supply source for the small retailers and premises. For other goods, Costco does provide a "wholesale" source to small retailers. Recently in Juneau, Alaska, distribution for resale at bars and restaurants for on-site consumption was allowed. As a result of this ability to sell for resale, about 40 percent of Costco's wine sales Juneau are now for resale. This demonstrates the efficiency of such a distribution option. The WSLCB regulation preventing resale therefore supports high distributor prices by eliminating a possible efficient distribution alternative. As a consequence, the resale regulation is anticompetitive.

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<sup>20</sup> RCW 66.28.070.

<u>Keith B. Leffler</u>	<u>6/3/05</u>
Keith B. Leffler	Date